Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

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Related Bills:	None.	Telephone:	845-3410	Introduced Date:	02/18/1999
		Attorney:	Doug Bramhall	Sponsor:	

SUBJECT: Employer New Full-Time Research Employee Credit

SUMMARY

Under the Personal Income Tax Law and the Bank and Corporation Tax Law, this bill would allow a credit of $1,000 for each qualified new employee engaged in qualified research employed by the taxpayer during the taxable or income year.

EFFECTIVE DATE

The credit would apply to taxable or income years beginning on or after January 1, 1999, for employees hired on or after January 1, 2000.

SPECIFIC FINDINGS

Existing state law, by conforming with specific modifications to the federal research expenses credit, allows a credit against tax for certain amounts paid or incurred for qualified research.

Qualified research expenditures eligible for the research tax credit consist of: (1) “in-house” expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; (3) 65% of amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called "contract research expenses"); and (4) 75% of amounts paid to a research consortium for qualified research if the research consortium is a tax-exempt organization and is organized and operated primarily to conduct scientific research, and the qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

To be eligible for the credit, the research must not only satisfy the existing research expenses deduction requirements but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors. In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys,

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market research or development, or routine quality control. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

This bill would allow a credit of $1,000 for each qualified employee employed by the taxpayer during the taxable or income year. A qualified employee would be all of the following:

1. A "new" employee, which is an employee who fills a newly created position that results in an overall net gain to the number of employees.
2. A full-time employee, which is an employee who works at least 35 hours per week.
3. Hired on or after January 1, 2000.
4. Engaged in qualified research within the meaning given under the research expenses credit provision.
5. At the end of the taxpayer's taxable or income year, employed by the taxpayer for more than six months, but less than three years.

The term "qualified employee" would not include any person previously employed by the taxpayer within the year prior to the taxable year. Thus, employees rehired within one year would not qualify.

Any portion of the credit not used in the taxable or income year could be carried over to future years until exhausted.

Since **this bill** does not specify otherwise, the general rules in state law regarding the division of credits among taxpayers would apply and this credit would not reduce regular tax below tentative minimum tax for the purposes of alternative minimum tax.

Policy Considerations

This bill does not specify a repeal date or limit the number of years for the carryover. Credits typically are enacted with a repeal date to allow the Legislature to review their effectiveness. However, once a repeal date has been added and the unlimited credit carryover is allowed, the department would be required to retain the carryover on the tax forms indefinitely. Recent credits have been enacted with a carryover limit since experience shows credits are typically used within eight years of being earned.

This bill does not contain a provision that would require the taxpayer to recapture the credit if the employee is terminated within a specified period. For instance, the economic development area hiring credits require employers to recapture the entire amount of credit taken for any employee who is terminated during a specified period of employment. This economic development area recapture provision contains certain exceptions, such as if the employee voluntarily left employment or was terminated due to misconduct.

Although this credit is not identical to other existing credits, taxpayers that would be eligible for this credit would be allowed credits for similar expenditures.

For instance, a taxpayer engaged in qualified research in an enterprise zone that pays qualified wages to a qualified employee could receive all the following:

1. An enterprise zone hiring credit for up to 50% of the qualified wages;
2. A research expenses credit, which includes wages paid or incurred to an employee for qualified research services; and
3. The credit provided under this bill for $1,000 per year for perhaps up to three years.

Implementation Considerations

This bill raises the following implementation considerations:

1. To be a “qualified employee,” this bill would require the employee be “engaged in qualified research.” However, this bill does not provide a quantitative basis for evaluating to what extent the employee’s services are related to qualified research. Specifically, this bill does not specify the amount of actual research activity required to be performed in order to qualify an employee for the tax credit (e.g., a one hour meeting of all employees at which research ideas are solicited potentially could qualify all employees in the credit base). Further, the bill does not specify the time period required for the net gain in employment (time of hiring versus end of year).

   Other existing hiring credits do provide quantitative bases. For instance, under the enterprise zone hiring credit, 90% of the employee’s services must be directly related to the employer’s enterprise zone business and at least 50% of the employee’s services must be conducted in the enterprise zone. This bill, because it does not specify a quantitative basis, would allow the taxpayer to claim a $1,000 credit for an employee who engages in any research services, from occasional to full-time.

   The lack of a quantitative basis for evaluating the extent of employee services necessary for the credit could result manipulation of the use of the credit.

2. By providing that “qualified employee” includes employees employed less than three years, it appears that the intent would be to allow the taxpayer to take the credit for the first three years of employment of that employee. However, the bill also states that “qualified employee” shall not include any person previously employed by the taxpayer within the year prior to the taxable year, which appears to disallow the second and third years of the credit. Therefore, it is unclear whether taxpayers would be allowed the credit for three years of employment or only for the first year in which the employee is employed.

3. This bill states that a “new” employee is one who fills a “newly created position.” This requirement leaves unclear whether the position must be newly created in the current taxable or income year, or some earlier income or taxable year.

4. This bill leaves unclear how the credit would flow through to investors of a pass-through entity. For instance, if the taxpayer is an S corporation, the general rule is that the entity is allowed to use only one-third of the credit generated for that year and passes through 100% of the credit to shareholders. However, under the research expenses credit, to which this bill refers, the credit is limited at the investor level to the amount of tax attributable the investor's interest in the pass through entity. Because the credit provision in this bill refers to the research credit and this bill is silent on the treatment of credits passed through, it is unclear whether the pass-through provisions of the research credit or the general rule would apply to this credit.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

This bill is estimated to impact the personal income tax and bank and corporation tax revenue as shown in the following table. The estimates assume that the employer is entitled to take a $1,000 credit per employee hired up to a maximum of three years.

This estimate assumes that the qualified employees would be required to perform substantially all of their work during the taxable or income year in qualified research activities.

Fiscal Year Cash Flow Effective For Hirings On Or After 1/1/2000 $ Millions			
	1999-0	2000-01	2001-02
Personal Income Tax	(Negligible*)	(Minor Loss**)	(Minor Loss**)
Corporations	($1)	($2.5)	($4.5)
Total	($1)	($2.5)	($4.5)

* Loss less than $250,000
** Loss less than $500,000

Tax Revenue Discussion

The revenue impact for this bill would depend upon the number of employers who employ qualified individuals for research in California and the amount of available tax liabilities of qualified employers.

<u>Note:</u> The revenue shown in the above table assumes that the bill will be amended to address the implementation concerns addressed above. If the bill is not amended to resolve these concerns, <u>the revenue impact of this bill could more than double</u>.

This estimate was developed in the following steps. First, according to the Employment Development Department (EDD), approximately 114,000 individuals were employed in qualifying research activities during 1998.

According to the same source, it is projected that an additional 5,500 individuals would be hired in the research industry for 1999. Second, this number (5,500) was grown 5% per year, yielding approximately 5,800 qualifying individuals that would be hired in 2000. This number was adjusted to account for those individuals who would meet the net increase in employment (75% assumption), leaving approximately 4,400 qualifying individuals for 2000. It was further assumed that only 50% of those individuals would qualify for the credit in year 2000 because of the minimum time requirement (six months), and the date they are hired within the year, leaving approximately 2,200 individuals. Third, the total number of qualifying individuals was multiplied by $1,000, generating $2.2 million in available credits for income/taxable years beginning in 2000.

For year 2001, it was projected that an additional 6,065 individuals would enter the workforce. This number was adjusted to account for net increase in employment (75% assumption), leaving 4,550 qualifying individuals for 2001. It was further assumed that only 50% of those individuals would qualify for the credit (timing requirement) and approximately 75% of the prior qualifying individuals in year 2000 (2,200) would qualify for the credit, leaving approximately 3,850 qualifying individuals for year 2001. For year 2002, it was projected that an additional 6,370 would enter the workforce. This number was adjusted to account for net increase in employment (75% assumption), leaving 4,775 qualifying individuals. It was further assumed that 50% of those individuals would qualify for the credit (timing requirement) and that 75% of the qualifying prior individuals for years 2000 (1,650) and 2001 (2,275) would qualify for the tax credit, leaving approximately 5,300 qualifying individuals for 2002.

Revenue estimates take into account the number of individuals who enter and leave the workforce, and that an employer who hires an employee in any given year could take a credit of $1,000 for that same employee up to three years, allowing one employee to qualify the employer for a maximum credit of $3,000 over three years. This is reflected in the increase in revenue losses for outer years. It was assumed that approximately 90% of allowable credits for personal income tax and bank and corporation tax would be applied against available tax liabilities in any given year by the research industry.

BOARD POSITION

At its March 23, 1999, meeting, the Franchise Tax Board voted 2-0 to take a neutral position on this bill.